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Federal Income Tax: Reporting of Gain or Loss on Exchange of Equipment Held for Productive Use for Property of Like Kind or Use

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FEDERAL INCOME TAX: REPORTING OF GAIN OR LOSS ON EXCHANGE OF EQUIPMENT HELD FOR PRODUCTIVE USE FOR PROPERTY OF LIKE KIND OR USE.

The trading-in of old equipment for new equipment is an every-day occurrence in the business world and almost invariably involves the question of the taxability of the gain or loss which accrues when the depreciated book value of the equipment traded-in is compared with the amount the taxpayer is allowed for this same equipment as part payment of the cost of the new equipment.

The problem can best be illustrated by an example. The taxpayer is a newspaper publisher and desires to trade-in an old printing press for a new printing press and the new press is to be used for the same productive use as the old press, that is, the production of newspapers. It should be noted at this time that the publisher is in the business of publishing newspapers and not in the business of selling printing presses, and that the transaction is in substance an exchange and not a sale. The old press originally cost the taxpayer $15,000. Annual depreciation charges have reduced the present book value of the old press to $5,000, and this figure is the depreciated cost to the taxpayer. The taxpayer, however, is allowed a credit of $10,000 for the old press towards the cost of the new press. From this, it is evident that a gain of $5,000 has accrued to the taxpayer as a result of the exchange. It is also evident that, had the taxpayer been allowed less than $5,000 for the old press, he would have sustained a loss from the transaction. A gain or loss of this kind is a gain or loss on the exchange of property held for productive use for property of like kind and use within the meaning of the Internal Revenue Code. In the following discussion, for the purpose of simplification, the words "gain" and "loss" will be limited to this specific connotation.

With this background in mind, the essential questions are: (1) what recognition, if any, is given such gain or loss; (2) if the gain or loss is not recognized at the time, what subsequent effect is given; and (3) if subsequent effect is given, what is the proper method.

The answer to the first question is found in the Internal Revenue Code[1], which expressly denies the recognition of the gain or loss at the time of the exchange. If there is a loss the taxpayer is not permitted to deduct it as an operating expense for the year in which the exchange is made nor is the government allowed to tax the gain as income. This is an exception to another code section[2], which recognizes generally gains and losses on exchanges. It should be noted that the exception is limited to exchanges of property, held for productive use, for property of like kind and use. It should also

[1] INT. REV. CODE sec. 112(b) (1) (1945).
[2] INT. REV. CODE sec. 112(a) (1945).

be noted that the exception does not apply to exchanges of stock in trade or other property held primarily for sale.[3]

The code provision[4] which denies recognition of the gain or loss has been approved by the federal courts in the few cases reported.[5] In the case of the *National Outdoor Advertising Bureau, Inc. v. Helvering*,[6] the company traded-in automobiles which its salesmen used for business purposes. The company contended that the transaction was a sale, and not an exchange, and that the loss should be allowed as an operating expense. The court held that the transaction was an exchange, and within the provisions of this section. That the provision may protect the taxpayer is shown in *Commissioner v. North Shore Bus Co.*[7] There the taxpayer traded-in old busses on which there was a mortgage. The bus manufacturer advanced the taxpayer the money necessary to release the mortgage and included this amount in the cost of the new machines. The Government contended that the money received by the taxpayer was income and therefore taxable. The court, in denying the Government's claim, said that the taxpayer merely exchanged creditors and that the transfer of the funds was only an incident of the exchange of the buses.

It is said that the non-recognition of the gain or loss at the time of the exchange is based on the theory that there has been no substantial change in the ownership of the property involved, that the new equipment is merely a continuation of the old investment unliquidated, and that the investment has changed in form only and not in substance.[8]

As to the second and third questions, it may be said that the gain or loss is given subsequent effect by making an allowance in determining the adjusted cost of the new equipment. This adjusted cost is the figure the taxpayer will use as his basis for calculating the future depreciation allowances on the new equipment; that is, the initial book value of the new equipment. In accomplishing this, gains are subtracted from, and losses are added to, the new cost.[9] No particular reason is given for this adjustment. The result, however, is reasonable since a gain only results when the depreciation on the old equipment has exceeded the actual depreciation or fair market value of the actual extent of depreciation; and that this method is the only available one by which the difference can be harmonized. The same may be said where a loss is adjusted, since a loss

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[3] INT. REV. CODE sec. 112(b) (1) (1945).

[4] *Ibid.*

[5] Trenton Cotton Oil Co. v. Com. Int. Rev., 147 F. 2d 33 (1945); Com. Int. Rev. v. North Shore Bus Co., Inc., 143 F. 2d 114 (1944); 454 C. C. H. 1945 Fed. Tax Serv. Par. 7293(M).

[6] 89 F. 2d 878 (1937).

[7] 143 F. 2d 114 (1944).

[8] *See* 462 C. C. H. 1946 Fed. Tax Serv. Par. 719.00.

[9] *See* 462 C. C. H. 1946 Fed. Tax Serv. Par. 776.0731 (Illustration of accounting method).

only occurs where the fair market value has decreased at a rate which is higher than the fixed rate of depreciation as charged by the taxpayer.

It is submitted that the provision is a reasonable one, that the taxpayer and the government are mutually benefitted, and that neither party can criticize the effect given it by the courts.

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